1st Farm Credit Services
YOUR FIRST CHOICE

Greg Davis
Chief Legal Officer

2000 Jacobssen Drive, Normal, IL 61761
Phone: (309) 268-0242 Fax: (309) 268-0243

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Mr. Barry F. Mardock
Deputy Director, Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Re: Regulatory Capital, Implementation of Tier1/Tier 2 Framework
(79 FR 52814, published on September 4, 2014)

Dear Mr. Mardock:

On behalf of 1st Farm Credit Services, thank you for the opportunity to comment on the Farm Credit Administration's proposed regulation on regulatory capital.

We appreciate the effort which FCA has put into modernizing the capital regulations of the Farm Credit System ("FCS" or the "System") and better aligning the System's regulatory capital rules with those of other federally regulated financial institutions. We believe that, on the whole, this modernization will enable external investors and others who are familiar with the Basel III framework[1] to better understand the financial strength and capacity of each cooperatively-owned System institution.

While we support the majority of FCA's proposed regulation, in certain respects FCA has proposed a far harsher approach to implementing the Basel III framework than the approach adopted by the U.S. banking regulators. This harshness undermines the appropriate comparability with Basel III that is one of FCA's stated goals in connection with the proposed regulation. On the other hand, in certain respects the proposed regulation does not adequately recognize and reflect the System's cooperative structure. Accordingly, we ask that FCA use its discretion and authority to modify the proposed regulation as described in this letter in order to (1) better align FCA's capital regulations with the System's cooperative principles and public policy mission and (2) better align FCA's capital regulations with the Basel III framework.

1st Farm Credit Services fully supports and agrees with the comments submitted on this matter by the Farm Credit Council ("FCC") and by AgriBank, FCB ("AgriBank"). In addition to the specific comments provided in this letter, we urge you to adopt each of the positions expressed in the letters from AgriBank and the FCC.

[1] The Basel III framework is available at http://www.bis.org/publ/bcbs189.htm. Unless otherwise noted, all references in this letter to "Basel III" or to the "Basel III framework" are intended to refer to the final capital rules of the U.S. banking regulators which implement the Basel III framework and which are found at 78 FR 62018 (October 11, 2013) (final rule of the OCC and the FRB) and at 79 FR 20754 (April 14, 2014) (final rule of the FDIC).

Reduce the Proposed Tier 1 Leverage Requirement to 4%

Unlike the federal banking regulators, which required a Tier 1 leverage ratio of only 4% when implementing Basel III, FCA is proposing a 5% Tier 1 leverage ratio for System institutions. We ask FCA to follow the other regulators in requiring a 4% Tier 1 leverage ratio for the following reasons.

First, the proposed 5% minimum leverage ratio is inappropriate for wholesale FCS banks because it fails to adequately account for the double-capitalization created by the System's cooperative structure. While it is true that System banks have a large portion of instruments in the 20% risk weight category – primarily the direct loans to their affiliated associations -- FCA appears to give no consideration to the two-tiered System capitalization. System associations and banks must capitalize retail loans at the same risk-based minimum levels as commercial banks, and in addition, System banks must capitalize wholesale loans to associations at a 20% risk weight. Due to this two-tiered capitalization, the System must effectively hold minimum capital for association retail loans totaling 120% of the amount required for commercial banks' retail loans. In addition, under this proposal, both the associations and banks will be subject to the capital conservation buffer, so total capital levels at both the banks and associations will be significantly higher than risk-based regulatory minimums. This capitalization level is more than adequate to protect against not only credit risk, but interest rate risk, liquidity risk, operational risk, and other risks. As a result, imposing a 5% minimum leverage ratio would create inappropriate economic incentives to shift ownership of loans from System associations to System banks.

Second, imposing a 5% Tier 1 leverage ratio creates an inherent competitive disadvantage for FCS lenders. Requiring an arbitrarily higher Tier 1 leverage ratio for System institutions, as compared with commercial banks, damages the System's safety and soundness by creating an inherent funding disadvantage for FCS institutions when competing with a commercial bank to offer financing to the same eligible borrower. There is no difference in risk, at the loan level, between a commercial bank and a FCS institution when providing financing to a specific agricultural borrower. As a result, there is no justification for imposing a higher Tier 1 leverage ratio on the System institution. We ask FCA to prevent this inequitable capital treatment.

Third, the proposed 5% Tier 1 leverage ratio requirement effectively reduces the FCS's ability to achieve its statutory mission, particularly during stressful periods, by decreasing lending capacity by over 20%, assuming that capital positions are near or at regulatory minimum levels. Under such an assumption, the impact of lower loan volume would materially reduce earnings, thereby adversely affecting safety and soundness. While too much leverage is problematic for financial institutions, FCA should recognize that too little leverage is equally problematic, particularly for mission-based lenders. The Basel III 4% minimum Tier 1 leverage ratio strikes the right balance in this regard.

Fourth, a 5% Tier 1 leverage ratio is an unnecessary deviation from Basel II which might cause confusion among investors. Because the proposed regulation arbitrarily imposes a higher Tier 1 leverage ratio on System institutions, FCA's regulation might cause unnecessary suspicion that the FCS is fundamentally riskier than other lending institutions. Ultimately, this suspicion could damage the System's safety and soundness.

Finally, there is no empirical justification for departing from Basel III requiring a 5% Tier 1 leverage ratio for System institutions. According to FCA, the proposed 5% minimum Tier 1 leverage ratio:

> "…takes into consideration the fact that System institutions are financially and operationally interconnected, member-owned cooperatives, and monoline lenders that currently provide credit to approximately 41 percent of the U.S. agricultural sector. They have a business model and risk profile that are substantially different from traditional banking organizations. The higher 5.0 percent leverage ratio also helps to ensure that System institutions continue to have sufficient systemic loss-absorbing capital to withstand a severely adverse economic event while continuing to provide a steady flow of credit to U.S. agriculture in view of the System's unique GSE mission. While System banks do have off-balance sheet items that would have to be risk weighted--especially unfunded commitments in this proposal--the banks also have a large portion of instruments in the 20 percent risk weighting category, primarily the direct loans to their affiliated associations, and the 0 percent risk weighting category. We believe it is important for System banks to hold enough capital to protect against risks other than credit risk (e.g. interest rate risk, liquidity risk, premium risk, operational risk, etc.)."

We respectfully disagree that these reasons justify a higher 5% minimum leverage ratio. Such an inference does irreparable harm to the FCS and its mission, particularly given the lack of any quantitative support for the difference. FCA's justification is insufficient and unsupported by experience or other factors, making this proposed requirement arbitrary and capricious.

Basel III was a response to systemic risks revealed during the financial crisis, largely originating from prevalent funding practices (such as reliance on short-term deposits, wholesale funding, overnight repurchase agreement and other forms of inter-bank transactions), and poorly regulated subprime residential lending and rating agency practices, that had the effect of correlating risk sensitivities. The inter-connections between financial institutions were revealed when losses at one institution drained capital and liquidity available to other institutions—even those with relatively high Tier 1 capital ratios. As liquidity dried up and mortgage-related losses further depleted capital, banks came under pressure to retire lower quality Tier 1 capital instruments (hybrid instruments) at a time when they were most needed to absorb losses. To address this phenomenon, Basel III prescribed a reduction in overall leverage, as well as an increase in both the quantity of capital (higher minimums) and the quality of capital (retained earnings rather than hybrid instruments) as essential to protect the banking system and its depositor base from systemic risks and the liquidity crises they engender.

The proposed rule says nothing about how the systemic risks that informed Basel III bear on System banks and their associations. No association that experienced financial distress over the past 6 years ever had its liquidity threatened, in stark contrast to the experience of many non-System financial institutions.

Basel III adopted a 4% minimum leverage requirement applicable to banking institutions in light of specific liquidity and credit risks unique to banking and residential lending practices. We acknowledge that the System has its own unique risks, primarily a concentration in agriculture. However, stress testing and economic capital modeling by System institutions provide evidence that System institutions "…continue to have sufficient systemic loss-absorbing capital to withstand a severely adverse economic event while continuing to provide a steady flow of credit to U.S. agriculture in view of the System's unique GSE mission."

Similarly, it is true that "System institutions are financially and operationally interconnected, member-owned cooperatives, and monoline lenders that currently provide credit to approximately 41 percent of the U.S. agricultural sector." However, it is not clear how this implies that FCS institutions need a higher leverage ratio than commercial banks. Interconnectedness of FCS banks and associations is in part a result of the two-tiered structure of the System, with each tier capitalized independently. System Banks are interconnected by virtue of joint and several liability for Systemwide debt obligations, and have implemented mechanisms to ensure each bank and district remains financially healthy. To state that System institutions are monoline lenders seems to imply greater risk for the System; however, the theoretically more diverse portfolios of commercial banks did not prevent them from experiencing severe stress during the 2008-09 financial crisis, while the System remained essentially unstressed. The financial crisis demonstrated a need for Basel III to achieve adequate capitalization of commercial banks, whereas System institutions were adequately capitalized prior to and during the financial crisis and functioned effectively. For FCA to now require FCS institutions to hold more capital than Basel III requires of commercial banks is not supported by facts, loss data, or any reasonable analysis of risk.

In short, there is no empirical basis to assert that System risks are more significant than the systemic risks that gave rise to the financial crisis and that were cited in Basel III as a justification for an increased leverage ratio. Certainly, there is no basis for a 25% higher leverage standard for the FCS. While we respect that FCA has regulatory discretion, the Agency should support its decisions with appropriate analysis of relevant data. FCA has not provided any reasonable facts or data analysis to support imposing the higher 5% minimum leverage ratio requirement.

For the foregoing reasons, we ask FCA to follow Basel III and the U.S. banking regulators by imposing a 4% Tier 1 leverage ratio requirement, rather than the proposed 5% minimum.

While we disagree with FCA's perspective that FCS institutions require a higher level of Tier 1 capital relative to other lenders in the marketplace, a reasonable alternative might be to adopt within the proposed framework a 4% Tier 1 leverage ratio regulatory minimum, but with an additional 1% Tier 1 capital conservation buffer. Admittedly, this is a deviation from Basel III, but it would implement FCA's apparent preference that FCS institutions maintain higher Tier 1 capital levels compared to commercial banks.

In considering this alternative, the Tier 1 leverage ratio capital conservation buffer should be made up of Tier 1 capital, and not CET1, as applied under Basel III relating to the unleveraged (i.e., risk-weighted) ratios. The additional flexibility is important, provides sufficient high-quality capital on a leveraged basis (i.e., non-risk weighted) and does not arbitrarily result in additional CET1 buffer requirements that deviate even further from Basel III. Similarly, the 1% Tier 1 leverage capital conservation buffer could be scaled across the payout categories, similar to the scaling of the CCB applicable to the risk adjusted capital ratios. Overall, a capital conservation buffer approach would support the objective of the proposed higher leverage ratio without unduly penalizing FCS banks that are primarily engaged in wholesale lending to associations.

While this alternative is a possible approach, it would be inconsistent with Basel III, and therefore it would be best if FCA did not complicate its rulemaking with a 5% Tier 1 leverage ratio or a Tier 1 leverage ratio capital conservation buffer.

Eliminate the "Unfunded Commitment" Amount for FCS Banks

The proposed requirement to treat FCS bank direct loans to affiliated associations as having an "unfunded commitment" amount that requires capitalization is inappropriate and not supported by the facts. As discussed in detail in FCC's response to FCA's question on this matter (see the response to question 7 in Appendix A of the FCC comment letter), the entire concept is without merit and inconsistent with the FCS cooperative structure. The FCS banks and their affiliated associations closely manage commitments to extend credit made to specific borrowers and the current regulations address capital requirements for such commitments. FCA is now adding to the already multiple levels of capitalization by proposing that direct loans have an unfunded commitment aspect that requires capitalization. We strongly disagree with this premise. FCA should remove the proposed requirement in its entirety and simply focus on commitments to "retail" borrowers.

Eliminate the 10-Year Revolvement Cycles for Association Investments in their Funding Bank to Qualify for CET1

FCA's application of a proposed minimum revolvement cycle to associations' investment in their funding bank is unworkable, anti-cooperative, and inconsistent with statutory re-affiliation provisions. The proposed CET1 requirement for a 10-year revolvement cycle for associations' investments in their funding bank creates challenging, bureaucratic, costly and burdensome restrictions on the capitalization of the bank without any discernible benefit in capital quality or quantity. In fact, it effectively implements a "first in-first out" redemption principle for an association's investment in the bank.[2] As a result, when a bank wants to retire capital either to equalize investments among its associations or to provide financial support to a struggling association, it must select stock that has been outstanding for more than 10 years. This would result in adverse tax consequence, if the oldest stock has a zero tax basis while more recently purchased stock has a full tax basis. In fact, such retirements would necessarily dissipate combined bank-association capital. FCA's proposed approach is inconsistent with Congressional intent and unnecessary to align its capital regulations with Basel III. Moreover, it makes it functionally impossible for associations to re-affiliate as provided for in the Act.

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[2] This FIFO rule recalls the pre-1971 Act, when Congress mandated that FICBs retire stock on a FIFO basis. See 12 U.S.C. 1071 (1969). The difference is that the pre-1971 law beneficially assisted the FICBs in making tax advantageous retirements of the old purchased stock (with full tax basis) before the more recent allocated stock, thus preventing retirements from dissipating System capital. The effect of the proposed rule is precisely the opposite.

In the closed, cooperative structure of the FCS, an affiliated association's capital investment is legally and functionally a permanent capital contribution to the bank and is understood as such by associations. This structure results in a permanent relationship that continues until liquidation, re-affiliation, or termination of System status, all of which require FCA prior approval. The level of capital an association is obligated to contribute to its funding bank is a percentage of its outstanding direct loan balance and is perpetual in nature as long as the association has a direct loan outstanding. The ability to adjust an association's capital investment in its funding bank assures that affiliated associations proportionately and appropriately share in the bank capitalization and risk of loss.

The permanence of the association's legal obligation to contribute to bank capital is entirely unaffected by how capital contributions are equalized among affiliated associations or if capital follows the association in the event of re-affiliation. Nor does the bank stock contain any feature that would allow an association to call its investment. The proposed 10-year revolvement of allocated equities means that the bank will not be able to function as a cooperative, including the ability to equalize capital contributions among affiliated associations or allow for re-affiliation in an appropriate way. It is unworkable to require association allocated equities that make up their capital investments in their funding bank to be outstanding for 10 years in order to be counted as CET1. These allocated equities are bank retained earnings and should be recognized as such. In addition, the proposed capital rule would not allow a reduction in the bank's CET1 without FCA approval. Therefore, FCA should treat the associations' stock investments in their funding bank as CET1 and exclude that capital from any minimum revolvement requirements.

The definition of capital applicable to an association's investment in a Farm Credit Bank (FCB) should differ from that of a member's investment in their association given the organizational structure of the FCS. Different capital definitions are justified for two reasons.

First, the Act establishes a structure whereby an association obtains its funding from a FCB with minimal opportunity to obtain funding from any other source.[3] FCA Regulation § 615.5000 sets out the financial interdependence between FCBs and affiliated associations as follows: "The **System banks**, acting through the Federal Farm Credit Banks Funding Corporation (Funding Corporation), **have the primary responsibility for obtaining funds for the lending operations of the System institutions**" (emphasis added).

Second, FCS banks have rights to call, preserve and build capital from their affiliated association borrowers that association's lack. A FCS bank's capitalization bylaws give it the ability to increase the investment requirement for existing direct loan volume, as well as the ability to retain excess investments with or without paying a return (patronage or interest credit) to the over-invested association. A bank's general financing agreement (GFA) allows it to increase spreads on existing advances immediately without Association approval.

An association's investment in a FCB results from the statutorily directed financial relationship, which is simply different from the financial relationship between an association and its members. While a member is required to capitalize an association, the member is also free to borrow from

[3] 12 U.S.C. 2073 – Section 2.2(12) states that associations "may borrow money from the Farm Credit Bank, and with the approval of such bank, borrow from and issue notes or other obligations to any commercial bank or other financial institution".

a financial institution other than the FCS. An association does not have this same flexibility and, as a result, its investment in a FCB is by statute and operation of law a permanent aspect of its capitalization, regardless if a FCB periodically equalizes such investment. While we had thought that treatment of cooperative equities could be identical throughout the FCS, it is not logical or desirable for FCB cooperative shares arising from affiliated associations' investments to be treated as identical to association cooperative equities.

Clarify Risk Weighting for High Volatility Commercial Real Estate

FCA should clarify the treatment of High Volatility Commercial Real Estate (HVCRE) as it pertains to traditional agricultural mortgages and eligible agribusiness or rural project financing transactions. The proposed definition of HVCRE and the associated 150% risk weight is unclear with respect to agricultural mortgages where the value of the land exceeds production value. While we do not believe FCA intended to imply that traditional agricultural mortgages are HVCRE, we are concerned that examiners will determine any financing that exceeds the agricultural production value needs to be risk weighted at 150%. Such a determination would essentially compromise the ability for the FCS to meets its statutory mission and would be inconsistent with the realities of today's agricultural mortgage marketplace. We also are concerned that FCA examiners will include agribusiness or rural project financing transactions to build processing and marketing facilities, farm related businesses, or rural infrastructure as being HVCRE. This does not appear to be the intent of this provision, but we are concerned that any such determination would undermine our lending mission going forward. We are therefore asking FCA to provide clarification on this issue in its final rule.

In this regard, we note that the federal banking agencies exempted from the definition of HVCRE loans to acquire, develop, or construct certain community development property[4] because such loans "promote the public welfare."[5] Because these mission-based bank loans serve important public policy goals, which include providing economic support to low-income communities that are often located in rural America, the banking regulators exercised their regulatory discretion to exempt them from the definition of HVCRE. Similarly, we note that loans made by System institutions to traditionally eligible farmers, ranchers, producers and harvesters of aquatic products, farm related businesses, and processing or marketing operations serve similar public policy goals. Accordingly, we encourage FCA to follow the example of the federal banking regulators and to clarify that loans to these traditionally eligible System borrowers to acquire, develop or construct property that will be used for traditionally eligible purposes are not HVCRE loans.

Eliminate the Shareholder Vote on Capitalization Bylaws Changes

The proposed capitalization bylaws provisions are fundamentally unworkable, unnecessary, costly, and legally problematic. If the member-owners do not approve the required bylaws changes, the institution would have to exclude from regulatory capital shareholder equities under GAAP, resulting in capitalization challenges. However, approving the required bylaws changes would undermine the institution's ability to function consistent with cooperative principles as

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[4] See, e.g., 12 C.F.R. § 3.2
[5] See, e.g., 12 U.S.C.A. § 338a.

expected by the Act.[6] Institutions with modest amounts of cooperative equities may prefer to exclude their cooperative equities from regulatory capital rather than endure the cost, member confusion, and uncertainty of a stockholder vote. Such a decision may make economic sense for a particular institution in isolation, but could lead to redemption of excluded cooperative equities, harming the overall regulatory capital position of the System.

The proposed bylaws amendment requirement may expose FCS institutions to legal challenge under general corporate law with respect to holders of allocation notices (qualified and non-qualified) who are not voting stockholders. Not all such holders will have a right under the existing FCA regulations to vote on bylaws changes that they may see as affecting their holder rights (e.g., retirement at the sole discretion of the board of directors). We fail to see the reason for this bylaws amendment provision because there is no basis for it in Basel III. It creates unnecessary complications to the proposed rule. FCA may hold the view that a bylaws change creates a clear legal distinction among various holders of allocated surplus and other equity to identify what is CET1, AT1 or T2 capital. We submit, however, that the permanence of allocated equity has already been addressed in the Act with respect to controls on capital retirements and other distributions retained by each institution's board of directors and the FCA.

We recognize the need to have clear distinctions between different holders of allocated equities to ensure they can satisfy the criteria associated with CET1, AT1, and T2. We do not agree, however, that a bylaws change is the best or even an appropriate way to accomplish this distinction. There is a better means for creating a clear distinction among allocated equities than requiring a capitalization bylaws change.

In particular, Section 4.3A of the Act requires that the bylaws adopted by shareholder vote shall enable System institutions to meet capital adequacy standards established under regulations issued by FCA.[7] As a result of this requirement, FCS institution bylaws provide the board of directors significant discretion for the management of capital resources to achieve ongoing compliance with regulatory capital requirements. Boards manage this compliance by adopting a capital plan as required by §615.5200.

The FCC has proposed that FCA can more appropriately and cost effectively address the expectation for a "legal distinction" within allocated retained earnings by modifying the proposed regulatory capital-planning requirement. We strongly support the FCC proposal. The modification would specifically require the board to adopt and establish a binding resolution on the treatment of retained and allocated equities to achieve ongoing compliance with the new capital requirements within the capital-planning requirement. The board resolution would be binding unless and only if modified by a change in the capitalization bylaws approved by all shareholders pursuant to §615.5220. FCA could require the resolution by regulation for the sole purpose of implementing the proposed regulatory capital requirements, which would effectively allow all FCS institutions to comply with these requirements without having to endure the uncertainty and risk of a shareholder vote, particularly if the vote may result in technical non-compliance with minimum capital standards.

[6] The U.S. banking regulators were careful not to require banks to reissue equities or change governing documents to satisfy the new CET1 standard. See Fed. Reg. vol. 78, No. 198, pages 62045-62046 (Oct. 11, 2013). FCA should provide the same level of consideration and sensitivity with respect to FCS cooperative equities.

[7] See 12 U.S.C. 2154a

Revise Treatment of System Allocated Retained Earnings

As implemented by U.S. banking regulators, Basel III includes all retained earnings in Common Equity Tier 1 (CET1) for all banking organizations, including mutual banks.[8] We support FCA following the lead of the U.S. banking regulators and ask that FCA include all FCS retained earnings in CET1.

Basel III recognizes two broad categories of CET1: (1) retained earnings and (2) paid-in capital instruments that meet a 13-factor test.

As to retained earnings, the rule is clear—CET1 includes all retained earnings. Basel III does not establish tiers of retained earnings. It does not subtract from retained earnings the amount that a bank has announced it plans to distribute to shareholders in the normal course of business. It does not apply a discount factor to retained earnings to reflect public market pressures to make quarterly dividend distributions (even when a bank's failure to make a dividend could ultimately increase its cost of funds or threaten its liquidity). Indeed, retained earnings are categorically included in a commercial bank's CET1, notwithstanding that the bank is generally free to distribute in a given year the sum of its total net income for that year, plus its retained net income for the preceding two years.[9]

FCA has proposed that FCS allocated retained earnings must have a 10-year minimum term in order to be treated as CET1. While we understand the importance of "permanence" with respect to CET1, there is no basis in Basel III for a 10-year holding period. Moreover, an allocated equity with an express minimum term of 10 years is no more permanent than an allocated equity that is perpetual on its face, particularly when a separate rule requires FCA consent for distributions that exceed 12-month trailing earnings. The proposed minimum term/revolvement period should be eliminated. Allocated equities are simply retained earnings and should be included in CET1 without qualification.

The proposed rule treats an institution's "allocation" of retained earnings as a capital distribution by the institution rather than as retained earnings by the institution. As a result, under most existing System institution bylaws, each dollar of retained earnings with a patron's name on it is automatically excluded from regulatory capital. This default exclusion applies to all forms of allocations, including FCB attributed surplus, ACB patronage surplus, and association written notices of allocation dating from the System's inception, in each case irrespective of retirement practices. As a result, approximately $11.2 billion of these forms of capital (12% of the System's aggregate capital before eliminations for combined financial reporting) will no-longer count as regulatory capital unless effectively reissued under new bylaw amendments.[10]

FCS's allocated retained earnings should be accorded capital treatment consistent with commercial banks' retained earnings. Allocated retained earnings do not possess the features identified in Basel III as having the effect of reducing loss absorbency (e.g., cumulative

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[8] 78 FR 62044 (October 11, 2013)
[9] See 12 U.S.C. 60(b) and 12 C.F.R. 5.63 and 5.64.
[10] This number is as of June 30, 2014 and includes so-called "URE equivalents" that would need bylaw amendments to qualify as CET1.

features); nor do allocated retained earnings possess any other feature that would cause an institution's condition to weaken during periods of economic or market stress.

The FCC letter cites several examples in which System institutions experiencing financial challenges suspended patronage distributions or significantly reduced allocated surplus redemptions with no material adverse effects to capital, liquidity or mission fulfillment. In each instance, the System institution's capital position stabilized and then improved after suspending patronage distributions or significantly reducing allocated surplus redemptions. Each institution resolved its financial challenges and resumed patronage distributions or increased allocated surplus redemptions, demonstrating that FCS institution retained earnings should qualify as CET1 without question or further qualification.

FCA has historically expressed concern with member-owner pressure for the payment of patronage dividends or redemption of allocated retained earnings. However, any pressure on FCS institutions to distribute retained earnings is not greater than the pressure on a commercial bank to make dividend payments from retained earnings. The U.S. banking regulators addressed these same concerns about shareholder pressure for distributions by requiring specific regulatory approvals. FCA should follow this approach.

Absent specific evidence that FCS institutions face greater pressure to distribute allocated retained earnings than commercial banks, FCA should not deviate from Basel III. FCA should treat FCS institution allocated retained earnings the same as U.S. bank regulators treat commercial bank retained earnings.

If FCA is determined to differentiate its treatment of FCS institution retained earnings from that of commercial banks, it should only do so through specific criteria applicable solely to retained earnings. While it is clear that the revolvement period does not impact the availability of cooperative equities to absorb losses, FCA has used revolvement as a basis for distinguishing among allocated equities in the current regulatory framework.[11] Although this concept is not included in Basel III, FCA could consider categorizing the treatment of retained earnings as CET1, Additional Tier 1 (AT1) or Tier 2 (T2) based on the pattern and practice of revolvement.

Under this concept, to qualify as CET1, FCS institutions could demonstrate a pattern and practice of revolving allocated equities on a 5-year or greater cycle pursuant to a loan-based capital plan. If a FCS institution does not follow a loan-based capital plan, it would demonstrate its plan, pattern and practice of revolvement by the year of allocation. Furthermore, FCA should recognize all affiliated association investments in the funding bank, including those arising from the allocation of retained earnings, as CET1 given the unique FCS structure as discussed below.

To qualify as AT1, FCS institutions could demonstrate a plan, pattern, and practice of revolving allocated equities on a 3 to 5 year cycle. Allocated equities not qualifying for CET1 or AT1 treatment under the criteria outlined previously would qualify as T2 capital. Overall, the

[11] We emphasize that a revolvement period is simply not relevant in the loss absorbing capacity of allocated equities and does not create an expectation or legal right relative to member-owners, particularly given the significant regulatory controls over revolvement. The proposed rule strengthens regulatory controls that would require adequate disclosures regarding the at-risk nature of the institution's equities and the prohibition of capital distributions or revolvement that would compromise the financial well-being of the institution.

approach outlined ensures that all stockholder equities under generally accepted accounting principles (GAAP) are included in regulatory capital measures. Under the proposed rule, FCA does not count all stockholder equities under GAAP as regulatory capital, which is inconsistent with Basel III.

Revise the proposed "safe harbor" provision that authorizes limited distributions, including stock retirements, without FCA prior approval.
Based on the premise that cooperative equities are included in CET1, we respect in principle that there must be restrictions on capital distributions. However, the proposed capital distribution "safe harbor" is too strict. Limiting capital distributions to the past year's net retained income and not allowing for any reductions in CET1 from the prior year-end provides no reasonable room to manage capital without seeking FCA prior approval. This burdensome requirement is far more restrictive than the Basel III implementation by foreign cooperative bank regulators and U.S. banking regulators for commercial banks. Foreign bank regulators understood that they had flexibility to allow up to at least a 2% reduction in CET1 as long as regulatory capital ratios remain compliant with the conservation buffer and all other requirements were met. U.S. banking regulators also recognized their flexibility when implementing capital distribution restrictions applicable to commercial banks. Under 12 CFR 208.5(c), commercial banks are permitted to distribute up to the sum of their current year net income, plus retained net income for the prior two years. Importantly, §208.5(c) is applicable to commercial banks with capital ratios above the capital conservation buffer requirement and that are not otherwise under supervisory remedy imposed by a U.S. banking regulator. FCA should be consistent with foreign and U.S. banking regulators and provide FCS greater flexibility to distribute capital.

Eliminate or change the unallocated retained earnings (URE) limit in the proposed Tier 1 leverage requirement.
The 1.5% URE requirement in existing FCS capital regulations should not be included in the new capital framework for the FCS. FCA has proposed that a minimum level of URE be maintained in the Tier 1 leverage ratio, which calls into question the cooperative structure of the FCS. The proposed URE requirement declares that URE is higher quality capital than CET1. Identifying a "super" or "superior" CET1 subclass is an unmistakable message to the marketplace that the System's CET1 does not match the CET1 of commercial banks. The result is reduced comparability and transparency.

Implementation of the 1.5% URE standard within the Tier 1 leverage requirement results in a minimum 3% URE held against each dollar of loans made by associations to member-owners, given the dual capitalization resulting from the System's cooperative structure. At this level of URE, the System may no longer function as a cooperative where the member-owners receive the benefits and risks associated with ongoing operations.

As proposed, the rule appears to unnecessarily infringe on a System institution's flexibility to implement governance processes that best support member-owners' ownership, control and engagement. Basel III did not establish URE as a "superior" class of CET1, and FCA has no basis to come to a different conclusion based on the at-risk and permanent nature of cooperative equities included in CET1. FCA should modify the proposed URE requirement to require FCS institutions to manage the components of CET1, including retaining a sufficient amount of URE, appropriate for the effective business operations through economic/business cycles. If FCA remains determined to require a URE standard, then the Agency should apply the URE standard on a risk-adjusted basis consistent with the current regulatory requirements. This approach would minimize unintended consequences resulting from the proposed URE requirement for System institutions operating as cooperative financial institutions. FCA's current regulatory requirements are the only global instance of a regulatory URE capital requirement relating to cooperative financial institutions. There is no factual or logical basis for FCA to continue to impose this requirement, let alone expand its impact on FCS institutions.

Maintain the 50% and 20% risk-weight treatment of rural electric cooperative assets

FCA should maintain the 50% and 20% risk-weight treatments of exposures to electric cooperative assets consistent with the treatment under the current regulations.[12] FCA previously acknowledged the lower risk profile of these loans because of: (1) the financial strength and stability of the underlying member systems; (2) the ability to establish user rates with limited third-party oversight; and (3) the exclusive service territories encompassing rural America. These unique characteristics insulate the rural electric cooperative industry from many of the credit-related risks experienced by investor-owned utilities, as demonstrated by the industry's minimal loss history and sound credit ratings through time and over many adverse business cycles.

Along with the low credit risk of this rural electric industry segment, the key institutions that provide financing to this segment other than CoBank and the U.S. government are not regulated. Therefore, it is critical that FCA's capital rules not affect the FCS's ability to compete and collaborate with the other lenders in meeting the financing needs of rural electric cooperatives. In fact, the Act is clear that the FCS's mission is to be a dependable source of credit and financial services for these cooperatives. For these reasons, the FCA should continue the 50% and 20% risk-weight treatments to ensure the FCS can continue to meet its mission to serve the rural electric industry. If FCA does not make this change, the proposed rule will adversely affect the FCS's capital capacity to serve this industry even though there is no loss or other risk justification for the proposed change. In the event FCA is unwilling to change the regulatory language, the final rule should reaffirm the current treatment that is established by Bookletter and permissible under the provisions of the proposed rule.

Conclusion

We appreciate the opportunity to provide input on this proposed regulation. The proposed regulation is important to modernizing the FCS's regulatory capital framework. However, we respectfully request that FCA make the changes described in this letter in order to (1) better align FCA's capital regulations with the System's cooperative principles and public policy mission and (2) better align FCA's capital regulations with the Basel III framework.

We appreciate FCA's consideration of our comments. If you have any questions regarding these comments, please contact me.

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[12] Under BL-053, FCA permitted the 50% risk-weight based on certain conditions and 20% risk weight based on AAA or AA rating by an NRSRO. We recognize that FCA is not able to rely on NRSRO ratings in regulatory capital provisions. Regardless, it is still clear that high-quality rural electric cooperatives should still be able to qualify for a 20% risk-weight based on their strong financial profile. One approach may be to rely on the FCS institutions' internal ratings for this specific industry.

Respectfully submitted,

1st Farm Credit Services

By: Greg Davis

Greg J. Davis, Chief Legal Officer

cc: Board of Directors
Gary Ash, CEO